Daiwa's View

Rising yields amid risk-on mode

➢ Market driver is rebound of global risk assets

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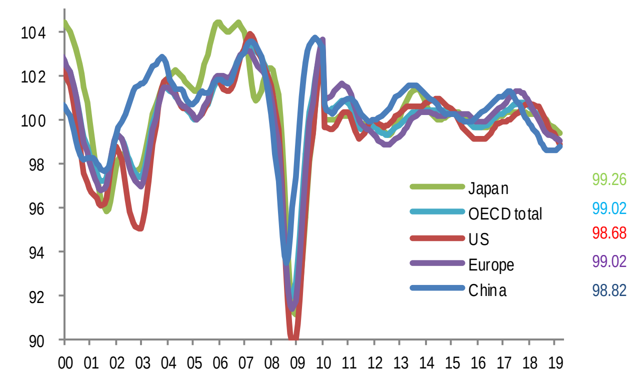
The OECD's overall composite leading indicator for July (released yesterday) came in at 99.02, declining for 20 months in a row. Although this is unquestionably low, the prolongation of the downtrend is also notable. This is because in the cases of the mini-recessions in 2012 and 2016, the average period before the OECD composite leading indicator bottomed was around 20 months (16-25 months). If we assume that the current 20-month downtrend (since Dec 2017) will follow the same pattern as the previous one, the index may hit a bottom in the not-so-distant future.

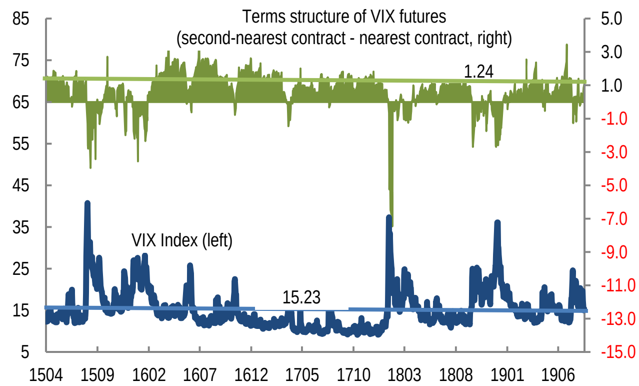
Of course, we need to be aware that past economic cycles may not be applicable due to the irregular factor of the US-China trade issue. Meanwhile, we are also focusing on the fact that the Chinese composite leading indicator improved for a fifth straight month in the midst of the trade issue, rising to 98.82 (left-hand chart below). Regarding the US-China trade issue, US Treasury Secretary Steven Mnuchin said yesterday that "we have made a lot of progress" toward trade talks, taking Chinese officials' visit to Washington as "a sign of good faith." If negotiations between the two nations proceed in a controlled manner and some sort of an agreement is reached, the news would be strongly reflected in a positive way in the market, which is now factoring in excessive pessimism.

Chart: OECD Composite Leading Indicator



Source: Bloomberg; compiled by Daiwa Securities.

Chart: VIX Index and Term Structure of VIX Index Futures

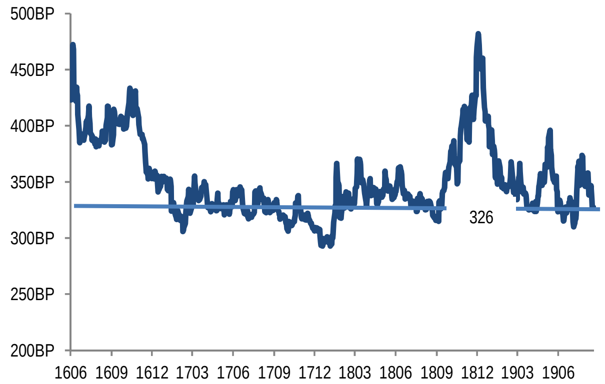


Source: Bloomberg; compiled by Daiwa Securities.

Under the circumstances, risk asset markets have recently been calm thanks to monetary easing by major central banks and expectations for the resultant economic recovery. The North American High Yield CDX Index, dubbed "a canary in the coal mine," improved to 326bp, the lowest level in three years. In addition, the Baltic Dry Index, which is sensitive to economic conditions, finally exceeded 2,500 for the first time since 2012 (right-hand chart below). In late August, we pointed out that "if risk assets strongly rebound going forward, the pace of yield declines would slow. In some cases, yields may rebound slightly." Such a condition is coming, and its speed and degree are outpacing our expectations. The risk-on trend is likely to continue.

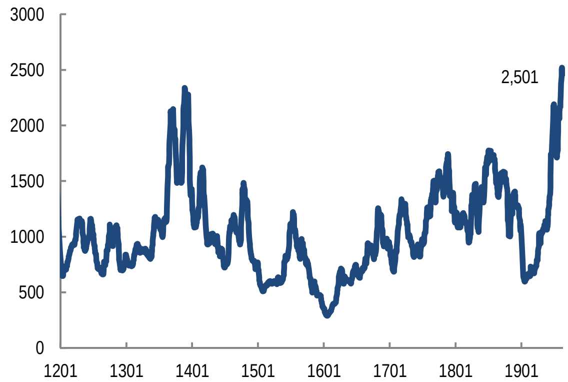
The JGB market would inevitably be influenced by this trend because overseas investors have been major JGB buyers thus far. The largest reason behind the rise in JGB yields (steepening) over the past several days is, of course, BOJ governor Kuroda's interview. However, we also need to pay attention to the fact that the impacts are amplifying as the phenomenon emerged in the midst of rebounds of global risk assets. In that sense, the driver in the current market is rebound of global risk assets.

Chart: North American High Yield CDX Index (5-year)



Source: Bloomberg; compiled by Daiwa Securities.

Chart: Baltic Dry Index



Source: Bloomberg; compiled by Daiwa Securities.

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■ Credit Rating Agencies

[Standard & Poor's]

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[Moody's]

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The name and registration number of the Registered Credit Rating Agency in the group: Moody's Japan K.K. (FSA commissioner (Rating) No.2)

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[Fitch]

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The name and registration number of the Registered Credit Rating Agency in the group: Fitch Ratings Japan Limited (FSA commissioner (Rating) No.7)

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May 2018

IMPORTANT

Notification items pursuant to Article 37 of the Financial Instruments and Exchange Law

If you decide to enter into a business arrangement with our company based on the information described in this report, we ask you to pay close attention to the following items.

• In addition to the purchase price of a financial instrument, our company will collect a trading commission* for each transaction as agreed beforehand with you. Since commissions may be included in the purchase price or may not be charged for certain transactions, we recommend that you confirm the commission for each transaction. In some cases, our company also may charge a maximum of ¥ 2 million (including tax) per year as a standing proxy fee for our deposit of your securities, if you are a non-resident.
• For derivative and margin transactions etc., our company may require collateral or margin requirements in accordance with an agreement made beforehand with you. Ordinarily in such cases, the amount of the transaction will be in excess of the required collateral or margin requirements**.
• There is a risk that you will incur losses on your transactions due to changes in the market price of financial instruments based on fluctuations in interest rates, exchange rates, stock prices, real estate prices, commodity prices, and others. In addition, depending on the content of the transaction, the loss could exceed the amount of the collateral or margin requirements.
• There may be a difference between bid price etc. and ask price etc. of OTC derivatives handled by our company.
• Before engaging in any trading, please thoroughly confirm accounting and tax treatments regarding your trading in financial instruments with such experts as certified public accountants.

* The amount of the trading commission cannot be stated here in advance because it will be determined between our company and you based on current market conditions and the content of each transaction etc.

** The ratio of margin requirements etc. to the amount of the transaction cannot be stated here in advance because it will be determined between our company and you based on current market conditions and the content of each transaction etc.

When making an actual transaction, please be sure to carefully read the materials presented to you prior to the execution of agreement, and to take responsibility for your own decisions regarding the signing of the agreement with our company.

Corporate Name: Daiwa Securities Co. Ltd.
Registered: Financial Instruments Business Operator
Chief of Kanto Local Finance Bureau (Kin-sho) No.108
Memberships: Japan Securities Dealers Association
The Financial Futures Association of Japan
Japan Investment Advisers Association
Type II Financial Instruments Firms Association